No. 10324

In the United States Circuit Court of Appeals

for the Ninth Circuit

UNITED STATES OF AMERICA, Appellant

vs.

CHINOOK INVESTMENT COMPANY, a corporation, Appellee

On Appeal from
The District Court of The United States
for the District of Oregon

Brief for the United States

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OPINION BELOW

The memorandum opinion of the District Court (R. 20) is unreported.

JURISDICTION

This notice of appeal (R. 33) involves federal income tax for the tax years 1936 and 1937 (R. 22-25). The tax for 1936 was paid by the taxpayer in 1937. (R. 22-23) A claim for refund was filed February 18, 1938 (R. 60-79) and an amended claim was filed June 29, 1939 (R. 23,

79-84). This amended claim for refund was rejected by the Commissioner on September 20, 1939. (R. 23) The tax for 1937 was paid by the taxpayer in 1938 and 1939. (R. 25) On February 27, 1939, a claim for refund for a portion of the tax then paid was filed and an amended claim therefor was filed June 30, 1939. (R. 25, 26, 93.) On September 24, 1940, an amended claim for additional refund was filed. (R. 26.) The claims for refund of the 1937 tax were rejected with the last rejection on April 1, 1941. (R. 26.) More than six months after filing these claims for refund and on September 18, 1941 (R. 2-8), the taxpayer instituted an action in the District Court for the District of Oregon for recovery of taxes paid. The judgment allowed the claim in full and was entered on June 16, 1942. (R. 32-33.) Within three months and on September 14, 1942, the United States filed a notice of appeal (R. 33) pursuant to the provisions of Section 128 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether losses sustained upon the sale of securities in the tax years 1936 and 1937 are deductible in full under Section 23 (f) of the Revenue Act of 1936 or are subject to the $2,000 limitation imposed by Section 117 (d).

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) Definitions.—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—(none of the deductions pertinent here).

* * * * *

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c): * * *

* * * * *

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(f) *Losses by Corporations.*—In the case of a cor-

poration, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

(j) *Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent provided in section 117 (d).

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(b) *Definition of Capital Assets.*—For the purposes of this title, "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * *

(d) *Limitation on Capital Losses.*—Losses from sales or exchanges of capital assets shall be allowed only to the extent of $2,000 plus the gains from such sales or exchanges. * * *

SEC. 351. SURTAX ON PERSONAL HOLDING COMPANIES. (As amended by Section 1 of the Revenue Act of 1937, c. 815, 50 Stat. 813)

There shall be levied, collected, and paid, for each taxable year (in addition to the taxes imposed by Title I), upon the undistributed adjusted net income

of every personal holding company a surtax equal to the sum of the following: :

* * * * *

SEC. 352. DEFINITION OF PERSONAL HOLDING COMPANY. (As amended by Section 1 of the Revenue Act of 1937, *supra*)

(a) *General Rule.*—For the purposes of this title and of Title I the term 'personal holding company' means any corporation if—

(1) *Gross Income Requirement.*—At least 80 per centum of its gross income for the taxable year is personal holding company income as defined in section 353; * * *

SEC. 353. PERSONAL HOLDING COMPANY INCOME. (As amended by Section 1 of the Revenue Act of 1937, *supra*)

* * * * *

(g) Rents.—Rents, unless constituting 50 per centum or more of the gross income. * * *

SEC. 357. MEANING OF TERMS USED. [As amended by Section 1 of the Revenue Act of 1937, *supra.*]

The terms used in this title shall have the same meaning as when used in Title I.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 22(c)-5. *Inventories by dealers in securities.*— * * * For the purpose of this rule (respecting

the reporting of inventories by dealers in securities) a dealer in securities is a merchant of securities, whether an individual, partnership or corporation, with an established place of business, regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom. * * * Taxpayers who buy and sell or hold securities for investment or speculation, irrespective of whether such buying or selling constitutes the carrying on of a trade or business, and officers of corporations and members of partnerships who in their individual capacities buy and sell securities, are not dealers in securities within the meaning of this rule.

ART. 117-2. *Limitations on capital gains and capital losses.*— * * *

Section 117(d) provides a limitation on deductions for capital losses affecting all taxpayers including corporations, that is, losses from sales or exchanges of capital assets shall be allowed as deductions only to the extent of $2,000 plus the gains from such sales and exchanges. * * *

STATEMENT

The relevant facts as found by the District Court may be briefly summarized as follows:

The taxpayer is an Oregon corporation authorized to buy and sell securities. (R. 21-22.) For the calendar year 1936 the taxpayer sustained losses from the sale of securities of some $40,035.02. (R. 26.) By virtue of this loss no

"net profits" were made for that year. (R. 28-29.) The income tax return filed by the taxpayer for 1936 showed no taxable income. The Commissioner thereafter assessed a deficiency of $4,071.89 as surtax on undistributed profits. (R. 22.) Payment was made in 1937 and 1938. A refund claim filed June 29, 1939, was rejected. (R. 23.)

For the calendar year 1937 the taxpayer sustained losses from the sale of securities of some $20,652.79. (R. 27.) By reason thereof no "net profit" was made for that year. (R. 28-29.) The income tax return filed by the taxpayer for 1937 showed a tax liability of $363.62 as undistributed profits tax which was paid. (R. 23.) Thereafter the Commissioner assessed a deficiency of $5,417.42 as a personal holding company tax on undistributed profits. The deficiency was paid in 1939. (R. 23, 25) Refund claims for the original tax and the deficiency were rejected. (R. 26.)

Assessments of the 1936 and 1937 deficiencies rested on application of Section 117 of the Revenue Act of 1936 to computation of undistributed profits tax and personal holding company undistributed profits tax. Under Section 117 (d) corporate losses on sales of "capital assets" are deductible only to the extent of the gains from such sales plus $2,000. Capital assets as defined in Section 117 (b) do not include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

On the basis of the evidence adduced the District Court found that during 1936 and 1937 the taxpayer bought and sold some $200,000 to $300,000 worth of securities for its own account and that the purchases and sales were made in both small and large transactions, through brokers and with private individuals. (R. 27-28.) This course of business was characterized by the District Court as follows (R. 27):

> That the stocks and bonds held by it [the taxpayer] during the said calendar years [1936 and 1937] were held by it primarily for sale to customers in the ordinary course of its trade or business, and not for investment or speculation, * * *

Accordingly the District Court held the losses sustained during 1936 and 1937 on the sales of securities were not capital losses under Section 117 but were deductible in full so that the taxpayer was subject to neither the undistributed profits tax for 1936 nor the personal holding company tax provisions for 1937. (R. 30.) Judgment for the full amounts claimed, $4,071.89 for 1936 and $5,781.04 for 1937, plus costs, was entered for the taxpayer. (R. 32-33.) From that judgment this appeal is prosecuted.

SUMMARY OF ARGUMENT

Section 117 of the Revenue Act of 1936, making losses on the sale of "capital assets" nondeductible in excess of

the gains from such sales plus $2,000, is applicable in determining the corporate "net income" on which are based the surtax on undistributed profits imposed by Section 14 and the surtax on undistributed personal holding company income imposed by Section 351 of the Revenue Act of 1936, as amended. Capital assets as defined in Section 117 exclude "property held by the taxpayer primarily for sale to customers in the ordinary course of his business". The legislative history of this exception makes clear, however, that it does not extend to securities held by investors or speculators. Such securities are "capital assets" under Section 117.

The evidence adduced before the District Court clearly established that the taxpayer's securities business was that of investment and speculation. The finding of the District Court to the contrary is not supported by the record. Moreover, such a finding is reviewable as one of law or mixed law and fact under this Court's previous decision in *Commissioner v. Boeing,* 106 F. 2d. 305. Since the securities sold by the taxpayer were held for investment or speculation they were capital assets within the meaning of Section 117 and the taxes complained of in this respect were properly assessed.

In light of previous decisions of the Supreme Court there is no substantial question presented respecting the constitutionality of the taxes so assessed.

ARGUMENT

I

Section 117 of the Revenue Act of 1936 Limits the Deductibility of Losses on the Sales of Securities by a Corporation Speculating or Investing therein

Section 117 (d) of the Revenue Act of 1936, *supra,* limits deductibility of losses from the sale of "capital assets" to the gains of such sales plus $2,000. This restriction on deductibility of such losses is clearly applicable to computation of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, *supra,* and the surtax on undistributed personal holding company income imposed by Section 351 of the Revenue Act of 1936 as amended by the Revenue Act of 1937, *supra.*

The tax levied by Section 14 of the Revenue Act of 1936 is based on the corporate "net income" minus certain credits not here relevant.[1] Definition of the term "net income" as used in the revenue act thus determines the applicability to computation of the surtax on undistributed profits of the limitation on deductibility of capital losses. As used in the various revenue acts the

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(1) It may be noted that certain deductions from net income for purposes of the normal tax imposed by Section 13, such as the dividend received credit provided in Section 13 (a) (2), are not allowed in computing the surtax on undistributed profits under Section 14. The base figure for both taxes is statutory "net income".

phrase "net income" is a term of art, made so by statutory mandate. It is a term precise and technical in content rather than a generality connoting concepts from accounting or economics.[2] Section 21 provides that " 'Net income' means the gross income computed under section 22 less the deductions allowed by section 23".

The "gross income", computed under Section 22, includes gains from any source and these gains are not to be diminished for gross income purposes by the losses on sales of "capital assets" within the meaning of Section 117.

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(2) It is elementary that the terms "earnings" or "profits" as used in Section 115, defining dividends, are unrelated to the concept of statutory net income. Paul, Selected Studies in Federal Taxation (Second Series, 1938) 155 *et seq.;* Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law, 89 U. of Pa. L. Rev. 865 (1941). None of the revenue acts has permitted deduction of all expenses and losses in ascertaining statutory net income. As Justice Holmes observed in *Weiss v. Wiener,* 279 U.S. 333, 335, "The income tax laws do not profess to embody perfect economic theory."

The surtax on undistributed profits has been sustained in situations where the corporate taxpayer has had nothing available for distribution, because the base for the tax is not profits available for distribution but statutory net income. *Helvering v. Northwest Steel Mills,* 311 U.S. 46; *Crane-Johnson Co. v. Helvering,* 311 U.S. 54 Cf. *Foley Securities Corp. v. Commissioner,* 106 F. 2d 731 (C.C.A. 8th). When Congress intends reference to earnings and profits in the accounting sense the phrase "net income" is not used.

The applicable regulations so provide.[3] Were it otherwise the provision in Section 23, *supra,* for deduction of such losses from gross income in ascertaining net income would be meaningless or produce a double deduction most certainly not intended by Congress. Section 23, enumerating allowable deductions from gross income, includes corporate losses in subsection (f). Subsection (j) of the same section provides, however, that losses from the sale of capital assets are governed by Section 117 (d). Thus it follows, as stated above, that the limitation on deductibility of losses from sales of capital assets is applicable to computation of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936.

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(3) Regulations 94, Article 351-2, issued under the Revenue Act of 1936, provides with respect to ascertaining liability for the personal holding company surtax that:

> The gross income for purposes of section 351 (b) (1) means (1) in the case of a domestic corporation its gross income as defined in sections 22, * * *. In determining gross income, subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold. Sales of capital assets as defined in section 117 must be treated as separate transactions and only those sales which individually resulted in profits shall be considered in determining the gains derived from such source. Gains from all transactions involving stock in trade, etc., are determined for the taxable year as a whole instead of separately.

It is also clear that Section 117 (d) is applicable to determining whether the taxpayer's income is personal holding income within the meaning of Section 353 of the Revenue Act of 1936, as amended, *supra,* so as to subject it to the surtax on such income imposed by Section 351 of that act.[4] As seen above, losses on the sale of capital assets within the meaning of Section 117 are not deductible in determining gross income under Section 22 of the Revenue Act of 1936 and are deductible in determining net income under Section 23 of that act only to the extent permitted by Section 117 thereof.

Section 357 of the Revenue Act of 1936, as amended, *supra,* requires that the terms imposing the surtax on undistributed personal holding company income must be given the same meaning as given them in Sections 21, 22 and 23. Hence, losses nondeductible by reason of Section 117 diminish neither "gross income" nor "net income" for purposes of ascertaining liability for the surtax on personal holding company income imposed by Section

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(4) The other requisite for classification of a corporation as a personal holding company under Section 352 of the Revenue Act of 1936, as amended, *supra,* is not in issue, i.e., more than 50 per cent of the value of the corporate stock was owned by five or less individuals at one time during the year. The return as filed by the corporation showed such ownership (R. 92) and the testimony of the only witness confirmed it (R. 118-120, 126).

351.[5] Thus, in determining whether rentals constituted 50 per cent or more of the taxpayer's gross income so as to remove it under Section 353 (g) of the Revenue Act of 1936, as amended, from the purview of the personal holding company surtax, losses nondeductible under Section 117 (d) cannot be applied to diminish gross income. Nor is the net income subject to the tax reduced by such nondeductible losses.

Application, by the taxpayer in the first instance (R. 51), of Section 117 (d) to losses from securities sold by the taxpayer in 1936 and 1937 so as to limit their deductibility to $2,000 resulted in assessment of the surtax on undistributed profits for 1936 and the surtax on personal holding company income for 1937. The complaint in this action to recover these taxes paid is based solely on the proposition that those losses were deductible in full. (R. 2-8.) Since, as seen above, Section 117 (d) is applicable to computation of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936

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(5) It is significant that Section 351 of the Revenue Act of 1936 as originally enacted provided that in determining "undistributed adjusted net income" subject to the tax on personal holding company income that nondeductible losses under Section 117 were to be deducted from "net income". No provision for such a deduction appears in Sections 351-360 of the Revenue Act of 1936, as amended by the Revenue Act of 1937, imposing the surtax on personal holding company income after December 1936.

and to ascertaining liability for the surtax on personal holding company income imposed by Section 351 of the Revenue Act of 1936, as amended, the question is reduced to whether the securities sold by the taxpayer were "capital assets" within the meaning of Section 117.

It was the taxpayer's contention before the District Court that the securities sold by it in 1936 and 1937 constituted "property held by the taxpayer primarily for sale to customers in the ordinary course of his [its] trade or business" within the meaning of that exception to the definition of all property as capital assets in Section 117 (b). (R. 13, 112-113.) The District Court so characterized the taxpayer's securities in its findings of fact. (R. 27.) However, in *Commissioner v. Boeing,* 106 F. 2d 305, 307, this Court held that such a finding is one of law or one of mixed law and fact so as to be reviewable.

The exception in Section 117 (b) from the definition of all property as capital assets of "property held by the taxpayer for sale to customers in the ordinary course of his trade or business" does not extend to securities held by a speculator or an investor however active his trading. The Circuit Court of Appeals for the Fifth Circuit squarely so held in *Commissioner v. Burnett,* 118 F. 2d 659. Accord: *Farr v. Commissioner,* 44 B.T.A. 683. The soundness of these decisions can be shortly demonstrated by reference to the legislative history of Section 117 of the Revenue Act of 1936.

Under the revenue acts prior to 1932 an investor or speculator in securities could deduct losses sustained on their sale without serious limitation.[6] To meet this situation the Revenue Act of 1932, c. 209, 47 Stat. 169, provided in Section 23 (r) that losses from sales of stock and bonds not classed as "capital assets" should be deductible only to the extent of the gains from such sales. An exception was made in the case of "dealers in securities". The Committee Report (S. Rep. No. 665, 72d Cong., 1st

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(6) As did prior acts, Section 101 of the Revenue Act of 1928, c. 852, 45 Stat. 791, restricting deductions for losses on sales of "capital assets", did not restrict deductibility of losses sustained on the sale of property, including securities, held less than two years.

Although losses on the sale of securities held for more than two years were deductible only to the extent of the gains from such sales plus 12½ per cent of the net loss on such transactions, an exception was made where the securities could be classed as "property held by the taxpayer primarily for sale in the course of his trade or business". Section 101 (c) (8) of the Revenue Act of 1928. (Note the absence of the phrase "to customers" present in the 1936 Act.) Under the same provision in the Revenue Act of 1932 the Board of Tax Appeals took the position that one regularly engaged in speculation in securities could by virtue of this exception deduct losses from such speculations in full, as ordinary losses. *Purdy v Commissioner,* 36 B.T.A. 572, affirmed, 102 F. 2d 331 (C.C.A. 1st). See generally 3 Mertens, Law of Federal Income Taxation (1942), Sec. 22.06.

Sess., p. 19 (1939-1 Cum. Bull. (Part 2 496)), referring to this exception, explained that:

> Traders or other taxpayers who buy and sell securities for investment or speculation, whether or not on their own account, and irrespective of whether such buying or selling constitutes the carrying on of a trade or business, are not regarded by your committee as dealers in securities within the meaning of this rule, and are not given exemption.

For similar statement by the House Committee see H. Rep. No. 708, 72d Cong., 1st Sess., p. 13 1939-1 Cum. Bull. (Part 2) 457).

In the Revenue Act of 1934, c. 277, 48 Stat. 680, the principle embodied in Section 23 (r) of the 1932 Act was given general application. Subsection (r) was eliminated and the provisions governing losses from sale of capital assets were broadened to cover that and additional ground by enactment of Section 117 of the Revenue Act of 1934 (carried over without change in the Revenue Act of 1936 applicable here). Under this section the period of ownership of property was not material to its classification as a capital asset.

Losses from the sales of all "capital assets" were deductible under Section 117 (d) of the Revenue Act of 1934 only to the extent of gains from such sales plus $2,000, hence special provisions for losses from sales of securities were superfluous. That the exceptions from this principle enumerated in Section 117 (b), defining

"capital assets", were not intended with respect to securities to enlarge on the exemption for dealers in securities under Section 23 (r) of the Revenue Act of 1932 is readily demonstrable. The exclusion in Section 117 (b) from the definition of capital assets of "stock in trade or other property of a kind which would properly be included in the inventory of the taxpayer on hand at the close of the taxable year" clearly does not include securities held by an investor or a speculator. The regulations under successive revenue acts included "dealers in securities" within the rule permitting the use of inventories in reporting income and *expressly excluded* investors and speculators therein.[7] The validity of this regulation is beyond question and rests upon a well settled distinction between dealers on the one hand and investors or speculators in security on the other. *Schafer v. Helvering,* 299 U. S. 171; *Vaughn v. Commissioner,* 85 F. 2d 497 (C.C.A. 2d); *Trading Associates Corporation v Magruder,* 112 F. 2d. 779 (C.C.A. 4th).

Nor does the final clause of subsection (b), "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" include securities

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(7) Regulations 74, Article 105, under the Revenue Act of 1928; Regulations 77, Article 105, under the Revenue Act of 1932; Regulations 86, under the Revenue Act of 1934, Article 22 (c) (5). The same provision appears in Regulations 94, issued under the Revenue Act of 1936, Section 22 (c)-5, *supra.*

held by investors and speculators. The language "primarily for sale to customers in the ordinary course of business" clearly connotes a merchant or a dealer as distinguished from a speculator or investor.

The phrase "for sale to customers", under the regulations above referred to, had for several years prior to 1934 been the indicia for determining whether a taxpayer held securities as a dealer on the one hand or as a speculator or investor on the other. *Seeley v. Commissioner,* 77 F. 2d. 323 (C.C.A. 2d). (See Regulations 94, Article 22 (c)-5, *supra*—the language is the same as that used in earlier regulations.) The same phrase appeared in the committee report on Section 23 (r) of the 1932 Act., above referred to, in making the same distinction.[8] That

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(8) S. Rep. No. 665, 72nd Cong., 1st Sess., p. 19 (1939-1) Cum. Bull. (Part 2) 496):

> The exemption from the restrictions of these provisions provided for in the House bill is retained in the case of a dealer in sercurities (i.e., a merchant of securities whether an individual, partnership, or corporation, with an established place of business, regularly engaged in the purchase of securities at wholesale and their resale to customers); in the case of losses sustained in connection with transactions with customers in the regular course of business.

The distinction between such a dealer in securities and an investor or speculator is made in that portion of the committee report set out in the text, *supra.*

Congress appreciated the meaning of the phrase cannot be gainsaid.

In fact, the conference committee report on the 1934 Act explains that the phrase "to customers" was inserted in the last clause of Section 117 (b) at the behest of the Senate "thus making it impossible to contend that a stock speculator trading on his own account is not subject to the provisions of section 117".[9] H. Conference Rep. No. 1385, 73d Cong., 2d Sess., p. 22 (1939-1 Cum. Bull (Part 2) 627. The basis for the committee's confidence was of course the judicial construction given that language in the regulations referred to and the obvious proposition that if property is held primarily for sale to customers in the ordinary course of business it could not be primarily held for any other purpose, i. e., speculative profit. In other words, the language used ("property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business") embraces only merchants or dealers, i.e., those whose profits represent the middleman's charge, and no others. Additional support for this view, if any is needed, lies in the fact that a special provision was deemed necessary to exempt certain types of banks investing in bonds from the operation of Section

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(9) Absence of that phrase had prompted the Board of Tax Appeals to hold under the Revenue Act of 1932 that securities held by a speculator were not "capital assets". See fn. 6, *supra.*

117 (d). Thus a trust company not within the terms of this special exemption was held subject to Section 117 with respect to investment losses in *Magruder v Safe Deposit & Trust Co. of Baltimore,* 121 F. 2d 981 (C.C.A. 4th).

From the foregoing it is clear that the exception in Section 117 (b) for property held primarily for sale to customers in the ordinary course of business extends only to dealers or merchants and that securities held by an investor or speculator therein are classed as capital assets subject to the limitation of Section 117 (d) for loss deduction purposes. In light of this the decision of the District Court is unsupportable. The evidence adduced before it entirely failed to establish that the taxpayer was a dealer in securities and on the contrary revealed that the securities sold in 1936 and 1937 were held by it as investment or speculative property.

The president of the taxpayer, appearing as the only witness, testified that from $200,000 to $300,000 worth of securities were bought and sold annually. (R. 109-110.) These figures are substantially higher than the activity reflected in the income tax returns. (R. 52-53, 88-89.) The return for 1936 showed also that the taxpayer sold stock held by it in that year in only eight transactions. (R. 52.) In describing the purchasing procedure the witness explained that for listed securities he followed the stock market every day "and when I find something

that looks reasonably well to buy, or if I have something that looks well to sell, I do buy or sell as I see fit." (R. 110.) Unlisted securities he bought "if I feel that the market justifies my buying I buy them; if I feel it justifies selling I sell them." (R. 111.) He testified further that many brokers solicited the taxpayer's business and that many of his transactions took place through such brokers. (R. 111-112.) In generalizing on the manner of the business conducted the president stated that "No. [The taxpayer never had anything it would not sell if profit was to be made.] Of course, we don't want to, but we did sell at a loss. We never salt it [securities] away, put it in a safe deposit box and say, 'We will never look at it again', saying it is a good investment. That wasn't the idea of the company". (R.116.) At the time of the trial the District Court characterized the taxpayer as a business where "he [the taxpayer's president] sought to make money as a trader for his own account, buying from the man who had to sell at a disadvantage, for reasons of his own, and selling, and the man who wasn't as good a buyer as Mr. Farrell was the seller". (R. 115.)

This testimony and the District Court's summation thereof would without more indicate the taxpayer was engaged in speculation exclusively with respect to its securities. The taxpayer's president also testified, however, that its securities were always purchased outright rather than on margin. (R. 112, 115.) Moreover, he testi-

fied further that all the securities sold in 1936 had been purchased more than four years before the time of sale. (R. 122.) (The securities sold in 1937 with two exceptions had been purchased during that or the preceding year. (R. 89.))

The income tax returns for 1936 and 1937, introduced into evidence as the taxpayer's exhibits, show that the only income from the taxpayer's securities business for those years consisted of dividends on stock in substantial amounts—$27,145.09 for 1936 (R. 49, 51), and $25,-188..70 for 1937 (R. 84, 85). The taxpayer's only other significant income was from rentals. (R. 51, 85.)

These several attributes of the taxpayer's securities business would indicate that it had a substantial investment aspect and the taxpayer's president admitted as much. (R. 120.) The fact that the securities sold in 1936 had been held more than four years certainly corroborates that admission.

On the basis of the evidence adduced there may be room for doubt whether the taxpayer's principal trading in securities was for investment or speculation. The evidence does clearly establish, however, that the taxpayer was an investor *and* speculator for the tax years involved *and not* a dealer or merchant in securities. The taxpayer's securities were not held as a "stock in trade" primarily for sale to customers in the ordinary course of business for the regular profit to be gained from such sale, as a charge for

the middleman's service performed. Cf. *Schafer v Halvering,* 299 U. S. 171. Those securities were held rather for dividends and for speculative profits on resale. Hence, the securities sold were capital assets under Section 117 and subject to the limitation imposed on deductibility of losses from sales of such assets. The finding by the District Court to the contrary is not supported by the record and involves complete rejection of the well settled presumption in favor of the validity of the Commissioner's determination.

The case of *Commissioner v. Burnett,* 118 F. 2d 659 (C.C.A. 5th), above referred to, is authoritative here. There the taxpayer had been engaged in buying and selling stocks and commodities on her own account through brokers on margin. She engaged in several hundred transactions annually involving many thousands of dollars. The Circuit Court of Appeals sustained the decision of the Board of Tax Appeals and held that the securities and commodities were not held as property "primarily for sale to customers in the ordinary course of his [her] trade or business" but were instead capital assets within the meaning of Section 117. Nor is the case to be distinguished here on the ground that the taxpayer there bought on the margin. Speculation by outright purchase is quite as feasible as the Board of Tax Appeals appreciated in *Farr v. Commissioner,* 44 B.T.A. 683. There the taxpayers were authorized to buy and sell securities. They

bought outright and sold large amounts of securities on their own account for speculative profits. Many of the sales were made to regular customers of the brokerage firm they also operated. The Board held on the authority of *Commissioner v. Burnett, supra,* that the taxpayers were dealers in securities so that losses from the sales of their securities were subject to Section 117.

As seen above, the crucial issue here is whether the taxpayer is a dealer in securities. Therefore the decisions in *Schafer v. Helvering, supra; Vaughan v Commissioner, supra; Seeley v. Commissioner, supra;* and *Trading Associates Corporation v. Magruder, supra,* holding that extensive investment or speculation in securities on an outright purchase basis does not entitle a taxpayer to classification as a dealer in securities, are likewise authoritative here.

On the basis of reason and authority it must be concluded that the taxpayer was not a dealer in securities for the tax years in question so that its securities must be classed as capital assets under Section 117 subject to the limitation on deductibility of losses on sales imposed by that section.

II

THE SURTAXES ON UNDISTRIBUTED PROFITS AND PERSONAL HOLDING COMPANY INCOME ARE CONSTITUTIONAL

There remains only to be considered the taxpayer's contention that application of Section 117 to sustain the undistributed profits tax assessed against it for 1936 and the personal holding company tax for 1937 is violative of the Federal Constitution.

In *Helvering v. Northwest Steel Mills,* 311 U.S. 46, and *Crane-Johnson Co. v. Helvering,* 311 U.S. 54, the Supreme Court sustained the validity of the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936. Similar constitutional considerations are pertinent with respect to the surtax on undistributed personal holding company income, and the validity of that species of income tax was sustained in *Foley Securities Corp. v. Commissioner,* 106 F. 2d 731 (C.C.A. 8th). Cf. *Helvering v. Nat. Grocery Co.,* 304 U.S. 282. Rejected in *Helvering v. Northwest Steel Mills, supra,* were charges that a tax on undistributed profits is not an income tax and that it interferes with state control over the internal affairs of corporations in violation of the Tenth Amendment. Hence, consideration need not be given here of similar allegations in the taxpayer's complaint. (R. 5, 7.)

Nor is there any substance in the allegation (R. 4) that the taxpayer had no income for either 1936 or 1937 so that exaction of a tax on undistributed profits for those years violated the Fifth Amendment. The returns filed by the taxpayer showed net income of $22,541.85 for 1936 (R. 54, 56), and $15,113.50 for 1937 (R. 85), and as seen above the taxes assessed and paid were based on that statutory net income—not on some generalized concept of profit or earnings. The net income reflected, it is true, application of Section 117 to limit losses deductible from the taxpayer's sales of securities to $2,000. As seen above, however, that was required by the terms of the Revenue Act of 1936 in ascertaining net income. Section 117, it should be noted, permits losses from the sale of capital assets to be deducted in full from capital gains in determining net income. The $2,000 limitation on deductibility of such losses is applicable only with respect to deduction of such losses from ordinary income. It was simply the taxpayer's misfortune to have sustained net losses on its sales of capital assets for the years in question.

Essentially, the taxpayer's allegation invoking the Fifth Amendment is a contention that losses from the sale of capital assets must, under the Constitution, be deducted in full from all other income before any tax on any income can be validly assessed. The fallacy in this proposition is, of course, the notion that Congress under the Sixteenth

Amendment can tax only an accounting species of "net income". None of the income tax statutes since the adoption of that Amendment has provided for deduction of all losses and expenses in ascertaining taxable net income. Thus there is an infinite variety of situations in which a taxpayer may sustain a net loss in the accounting sense but nevertheless have net income within the meaning of the revenue acts subject to tax. The validity of statutory disallowance of particular items has been approved by the Supreme Court in numerous cases. *Brushaber v Union Pac. R. R.,* 240 U.S. 1; *Stanton v. Baltic Mining Co.,* 240 U.S. 103; *Tyee Realty Co. v. Anderson,* 240 U.S. 115. In more recent times the Court has stated simply that deductions are matters of Congressional grace. *New Colonial Co. v. Helvering,* 292 U.S. 435, 440; 4 Mertens, Law of Federal Income Taxation (1942), Sec. 25.03. Limitations on deductions of capital losses from ordinary income have been an integral part of our revenue acts since 1924 and cannot now be questioned. *United States v. Pleasants,* 305 U. S. 357. So here, in conformity with that principle, as the taxpayer received statutory net income for the tax years in question, it is subject to tax thereon without regard to its nondeductible capital losses.

Finally, it may be observed that the taxpayer can complain of no hardship resulting from imposition of the surtaxes for 1936 and 1937 on undistributed profits. As seen above, the corporation had net income in those years

within the meaning of the revenue acts. Moreover, its balance sheets showed earned surplus and undivided profits from earlier years remaining at the close of 1936 of some $225,709.31 (R. 53) and $208,899.19 as of the close of 1937 (R. 88). The surtaxes on undistributed net income could have been escaped entirely by distributions of undivided profits from prior years in the amount of the statutory net income for the tax years in question. In much stronger cases, from the standpoint of sympathy for the taxpayer, the surtax on undistributed profits imposed by Section 14 of the Revenue Act of 1936 was sustained in *Helvering v. Northwest Steel Mills, supra,* and *Crane-Johnson Co. v. Helvering, supra,* where deficits from prior years prevented the corporations from declaring dividends and escaping the tax.

CONCLUSION

The decision of the District Court was erroneous and therefore should be reversed.

Respectfully submitted,

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